EY ITEM Club Summer Forecast

Headwinds persist

July 2025

The better the question. The better the answer.
The better the world works.

EY

Shape the future
with confidence

Ernst & Young LLP (EY UK) is the sole sponsor of the ITEM Club, the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.

Contents

Foreword

Anna Anthony
UK&I Regional
Managing Partner
Ernst & Young LLP (UK)
LinkedIn

Peter Arnold
UK Chief Economist
Ernst & Young LLP (UK)
LinkedIn

One of the familiar characteristics of the last five years has been the rate at which economists' forecasts go out of date. A continuous cycle of geopolitical and economic shocks, combined with unpredictable market volatility, has led to an almost constant need to recalibrate forecasts. It therefore could be seen as slightly reassuring that the EY ITEM Club summer forecast is largely unchanged from the spring.

While GDP growth for 2025 has been upgraded to 1.0% from 0.8%, reflecting a stronger Q1 than expected, this was largely driven by UK businesses bringing investment activity forward in anticipation of US tariffs. The ongoing uncertainty of where tariffs will land, and the expected impact when they do, means the outlook for 2026 is held at 0.9% before returning to 'normal' growth (of sorts) of 1.5% in 2027.

Inflation is proving stickier than hoped – driven by higher energy prices, increases in index-linked utility bills and rising pay in some parts of the public sector. However, we expect the Bank of England to continue to cautiously cut rates, particularly as the labour market is showing signs of softness. Hence the outlook for interest rates is also unchanged from our last forecast; with two further cuts expected this year and a target rate of 3.5% expected to be hit in early 2026.

So far, so unexciting and in line with predictions! However, there remains a set of risks (on both upside and downside) that keep life interesting for an economist. Equity markets seem to have (for now) shrugged off the impact of tariffs – presumably in anticipation of some UK-style deals to mitigate the worst of any tariff impact, and trust in the ever-resilient US consumer. This could prove optimistic as even if deals are done, average US tariffs on imports will still be 4-5 times higher than before.

More positively, while consumer and business confidence remain fragile, the fundamentals for both are improving, which could offer some upside. On the consumer front, real incomes have finally recovered from the inflationary shock of 2022/23, and with nominal wages still outstripping inflation, this should support a recovery in consumer spending. Consumer balance sheets remain healthy; on average consumers are still saving more of their disposable income (11%) than the 2010 average (closer to 8%). If confidence improves, consumers may choose to spend more, particularly as falling interest rates reduce the incentives to hold cash in bank accounts. Set against all this is an increasingly fragile labour market, where the increase in National Insurance contributions and the National Minimum Wage, has led to a slowdown in hiring, particularly in consumer facing services (e.g., hospitality and retail).

On the corporate front, balance sheets are remarkably healthy but the cost of capital (stemming from higher interest rates) risks holding back investment. Lower rates should help, but the demand-side matters, bringing us back to tariff uncertainty and its likely impact on world trade.

However, there still remains a set of risks (on both upside and downside) that keep life interesting for economists, while contributing to a continued atmosphere of disruption and uncertainty for businesses.

Highlights

- The UK economy made a strong start to the year but, sadly, the momentum didn't last. The first quarter was boosted by some activity being brought forward to beat April's introduction of US tariffs, and the signs are that momentum has been lost into Q2. While we don't expect a recession, we continue to expect weak growth over the remainder of this year and into the start of 2026. Nonetheless, the strong start to the year has contributed to our revision of the 2025 GDP growth forecast to 1.0% from 0.8%. We still expect growth to be 0.9% next year, before settling at 1.5% from 2027.

- The UK was successful in agreeing the basis for a trade deal with the US. However, this only partially mitigates the impact of US tariffs, and uncertainty around the global economic outlook remains significantly higher than normal, although the risk of the most extreme tariff scenarios has decreased. Combined with a weaker international economy, these contribute to a slowdown in exports. While at home, continued uncertainty will delay major spending decisions, particularly among businesses.

- Some cracks have started to emerge in the UK labour market, and we expect them to widen a little further. But we do not expect it to break. While hiring has slowed, there has been a drop-off in employment reflecting the increase in employers' NICs, but we are yet to see wide-scale layoffs. We forecast unemployment to rise to 5% by the end of the year, but to settle back to around 4.5% by the end of 2027.

- Inflation has risen above 3% once more and is expected to remain at this level for the rest of this year. The recent pickup reflects an increase in energy bills and one-off price changes. However, the progress towards the 2% target will be slow. Wage growth will ease over the course of this year, but the rise in employers' NICs means growth in labour costs will remain high. This will only ease next year, and we eventually see inflation falling back to target in the latter half of 2026

- The Monetary Policy Committee is still more concerned about cutting interest rates too quickly rather than too slowly. We think they will continue to reduce interest rates once a quarter until the first quarter of next year, with Bank Rate falling to 3.75% by the end of this year and settling at 3.50%.

- The UK's fiscal dynamics are very challenging and are becoming increasingly difficult. In response to high debt, high interest rates, and a track record of weak growth, the UK Government has set out plans that see taxes rise more quickly than spending. However, it may still not be enough to meet its rule of only borrowing to invest, as welfare reforms, disappointing growth and the imposition of US tariffs will worsen the UK's fiscal position. Tax rises are looking increasingly likely at the Budget later this year.

- In more positive news, a gradually more optimistic consumer will likely see household spending growth continue. With slowing pay growth and a pickup in inflation, real earnings growth is set to slow. We expect households to start saving less, given their relatively healthy balance sheets. Furthermore, elevated uncertainty and the rising cost of essentials will see some spending on discretionary items muted in the near term.

- The housing market is currently going through a soft patch, but we think it will prove only temporary. As the distortions from April's Stamp Duty threshold change fade, we expect moderate performance in the housing market in the second half of this year, with interest rates set to fall, but housing valuations remaining relatively stretched. Planning reforms open the door to more house building, but construction costs and labour market shortages could cap any increase over the coming years.

1

Introduction

In our spring forecast, we set out some of the growth challenges facing the UK this year and next.[1] Over the last few months, economic momentum has faded, and domestic and global headwinds continue to hold back growth prospects over 2025 and 2026. On a more optimistic note, we expect growth to improve in 2027 as the UK's solid economic fundamentals come to the fore.

Our latest forecast first sets out the economic developments of the last three months and their implications for the outlook, before examining the key factors that are expected to shape the behaviour of consumers and businesses over the next couple of years.

2

Momentum has faded

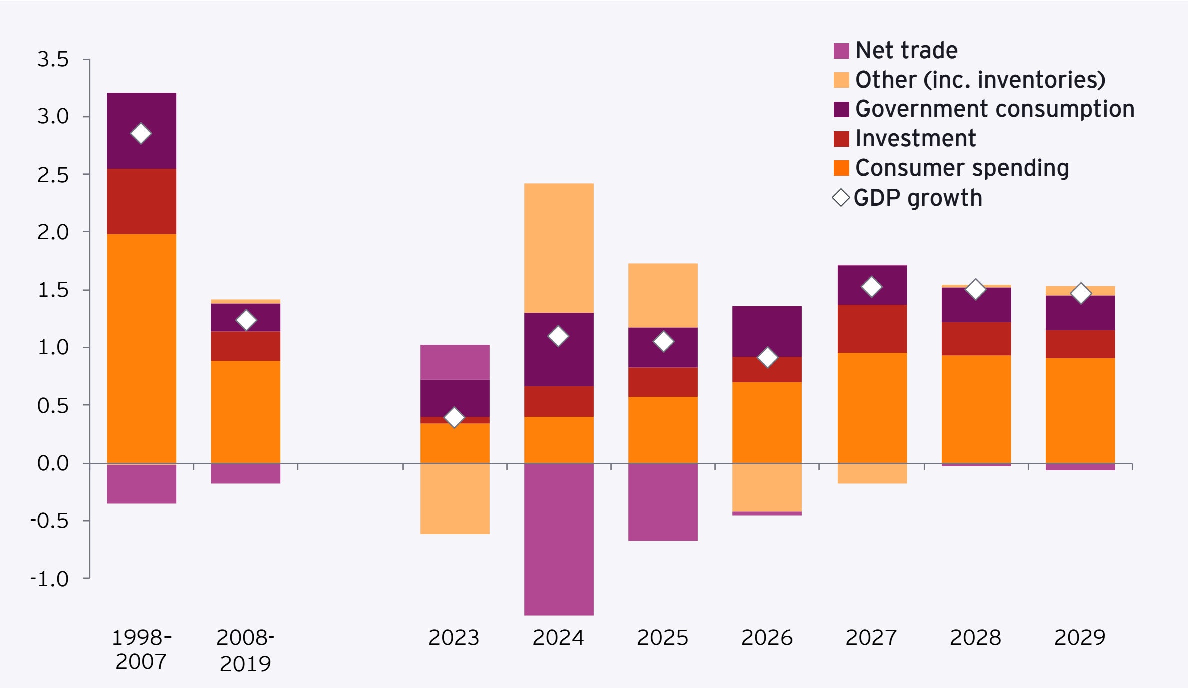
Although the UK made a strong start to 2025, there were signs that it would be fleeting, and higher-frequency indicators suggest growth has slowed in Q2. Softer real income growth, tight monetary and fiscal policy, and changes in international trading arrangements are still expected to weigh on growth this year and next. In response to the strength of Q1 and a slight improvement in the trade backdrop, we have revised up our 2025 growth forecast to 1.0% from 0.8%, and the 2026 growth forecast remains at 0.9%.

Signs are that the economy is starting to slow

Having ground to a halt at the end of last year, growth picked up sharply in Q1 with the Office for National Statistics (ONS) estimating that output increased by 0.7% on the quarter. However, scratch below the surface, and the details suggested that the pickup would likely be short-lived. Since the middle of last year, we have argued that residual seasonality has resulted in activity being overestimated at the start of the year and underestimated in the latter half. Additionally, some of the pickup in growth was driven by a big jump in business investment, which increased by 3.9%, but a large chunk of that reflected business being pushed through ahead of April's policy changes. Likewise, the sharp rise in exports in Q1 reflected US importers stockpiling ahead of April's tariff increase.

UK: Contributions to GDP growth

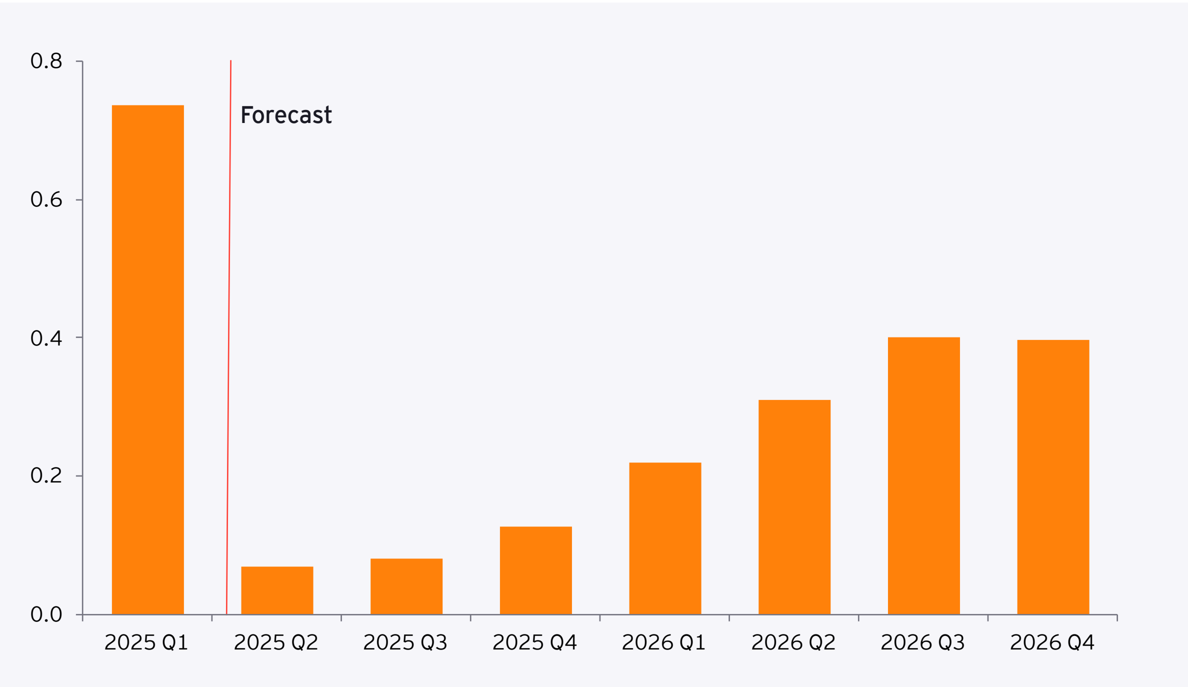
% pts



Source: EY ITEM Club

UK: GDP growth

% quarter



Source: EY ITEM Club

There are already signs that growth will slow sharply in Q2. Output fell by 0.3% and 0.1% in April and May, respectively. The imposition of tariffs saw weakness in the manufacturing sector and the largest decline in goods exports to the US since 1997. As some of Q1's ephemeral strength fades and the effects of tariffs start to be felt, we expect growth to slow sharply in Q2 and remain around 0.1% to 0.2% over the second half of this year and at the start of next.

Forecast for the UK economy, summer 2025

% changes on previous year except borrowing, current account and interest and exchange rates

	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2022	4.8	5.1	7.4	5.1	12.6	13.0
2023	0.4	0.0	0.5	0.3	-0.4	-1.2
2024	1.1	2.4	0.6	1.5	-1.2	2.7
2025	1.0	1.7	0.9	1.4	0.7	2.6
2026	0.9	0.9	1.1	1.3	-0.4	-0.3
2027	1.5	1.5	1.5	2.3	1.3	1.2
2028	1.5	1.5	1.5	1.6	1.6	1.5
2029	1.5	1.5	1.5	1.3	1.6	1.6

	Net govt. borrowing (*)	Current account (% of GDP)	Average earnings	CPI	Bank Rate	Effective exchange rate
2022	4.9	-2.2	6.4	9.1	1.5	79.7
2023	4.8	-3.5	6.9	7.3	4.7	80.5
2024	5.1	-2.7	5.3	2.5	5.1	83.6
2025	4.1	-2.9	4.5	3.4	4.2	85.1
2026	3.3	-2.8	3.3	2.6	3.5	85.4
2027	2.7	-2.7	2.9	2.0	3.5	85.4
2028	2.6	-2.6	2.8	2.0	3.5	85.4
2029	2.5	-2.5	2.9	2.0	3.5	85.4

(*) Fiscal years, as % of GDP

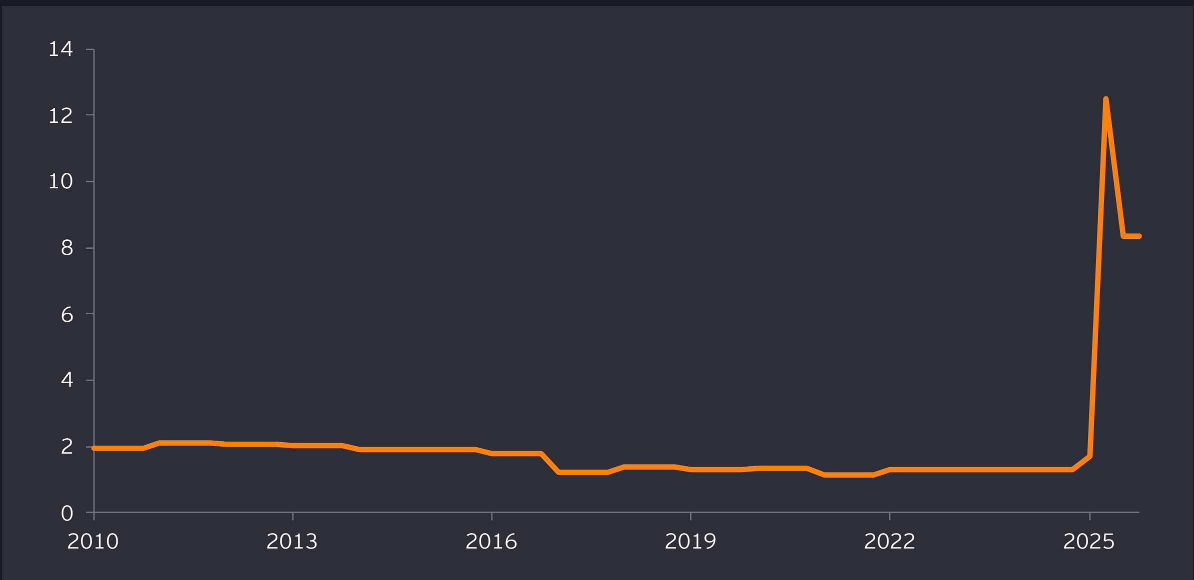
Source: EY ITEM Club

Progress on trade policy is not a game-changer

Since our last forecast, the UK has struck a trade deal with the US. Although its scope is limited, focusing on certain sectors – cars, aerospace, steel and agriculture – the UK will still face a 10% tariff on most goods exported to the US. Therefore, the agreement still represents a significant reduction in access to its largest export market, with the average tariff rate applied to UK goods increasing by more than seven percentage points. Although the agreement will offer some support to specific sectors, its broader macroeconomic impacts are likely to be small. The UK has also agreed a deal with the EU. However, we believe its macroeconomic significance is limited, although there may be a small benefit to the food and drinks industry. The pact largely focused on an agreement to seek to negotiate a closer future UK-EU trading relationship, so it is not a game changer for our forecast.

UK: Tariff applied to goods exports to the US

%



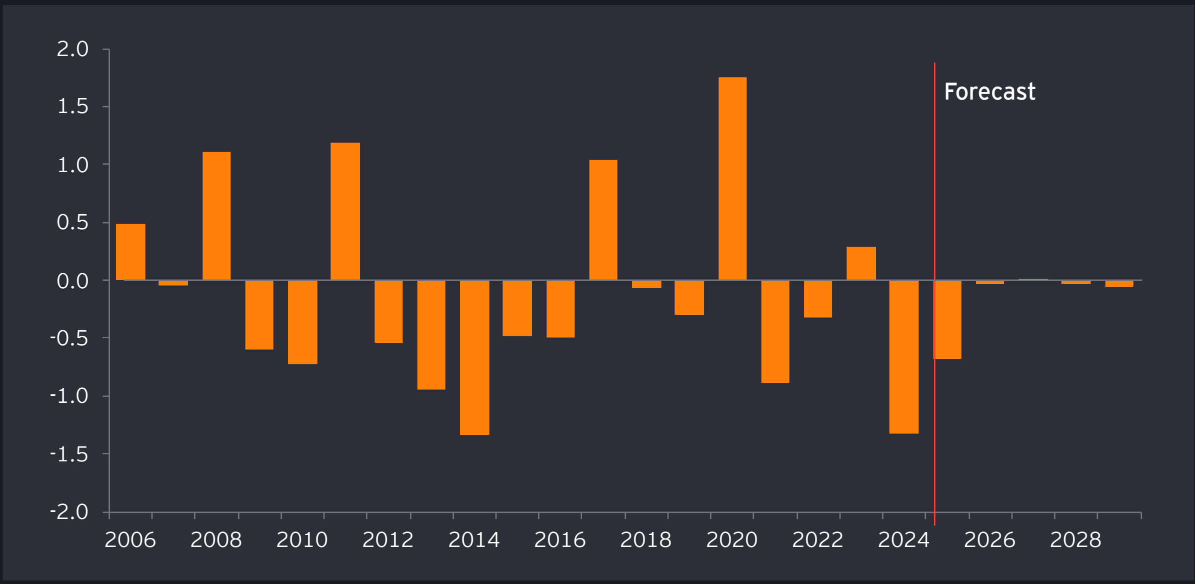
Source: EY ITEM Club/ US International Trade Commission

The US administration has delayed the imposition of tariffs until 1 August as the US continues to work on trade deals with other partners. To date, the US has only struck deals with the UK and Vietnam. Nonetheless, the average effective tariff rate is still expected to rise to around 19%, lower than the 25% announced on 2 April, but still a huge uptick compared with before. This could still see world GDP growth slow to below 2.5%, from around 3% in the years immediately after the pandemic.

Following the strong start to Q1, we expect exports to fall back through the course of 2025 and into 2026. As a result, we forecast modest growth in exports of 0.7% this year, followed by a 0.4% decline in 2026, with net trade expected to act as a drag on growth over the next couple of years.

UK: Contribution of net exports to GDP growth

% year



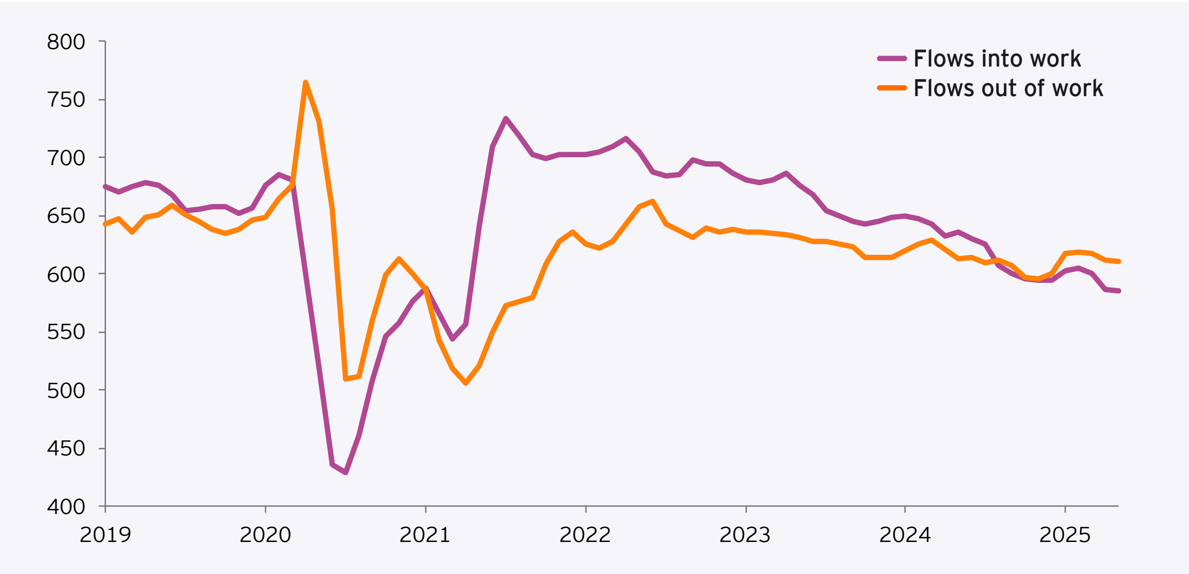
Source: EY ITEM Club

The labour market's orderly adjustment will continue

Having previously been very tight by historical standards, two years of relatively weak economic growth have seen the labour market loosen. Ongoing issues with the ONS Labour Force Survey have clouded the picture somewhat, but the overriding story so far is one of an orderly labour market adjustment, with businesses slowing hiring rather than resorting to large-scale layoffs. In the last couple of months, signs of some labour market slack have started to emerge.

UK: Flows into and out of payrolled employment

000s of people, 3m average



Source: EY ITEM Club/ Haver Analytics

Overall, the number of employees has started to fall more rapidly in recent months. This reflects a combination of weak growth as well as the rise in employers' NICs and the National Living Wage (NLW). This has led to a decline in the number of job openings and a slowing of the inflows to the national payroll. In contrast, we have not yet seen businesses shed a lot of labour. Outflows from payrolls have remained close to historic norms, while there has not been a big increase in redundancy notifications.

With the UK set for weak growth, but growth nonetheless, over 2025, we do not expect a large increase in redundancies. We do expect hiring to slow, further pushing the unemployment rate from 4.7% at the start of this year to 5.0% by the turn of 2026 before settling around 4.5% in 2027. Of course, the increase in the unemployment rate means an increase in joblessness. However, it's important to put this move into context. For example, during the global financial crisis (GFC), the unemployment rate rose to over 8%.

With the labour market loosening, pay growth has already slowed. But as it stands, with private sector earnings recording growth of 5.5% in Q1, there is scope for wage growth to slow further. The Bank of England's survey of corporate decision-makers suggests pay settlements have been in the region of 3.5%. With less job churn, greater unemployment, and households having experienced strong real income gains last year, we expect pay growth to fall back to about 3.5% by the end of the year, before slowing further to around 3% in the latter half of next year.

How the change in NICs and the NLW is impacting the labour market

April marked a big shift in the UK labour market, with the increase in employers' NICs announced at the Autumn Budget and another large rise in the NLW to £12.21 coming into effect. Together, this means that the growth in firms' labour costs remains elevated, and little changed from last year, despite cooling wage growth.

However, this effect is not felt evenly. Cost rises are most acutely felt by employers who typically rely on lower-paid staff who work fewer hours per week. These businesses will feel the effect of the large rise in the NLW and the reduction in the threshold at which employers' NICs are paid, the latter of which saw the annual earnings threshold of £9,100 fall to £5,000. Estimates indicate that the cost of employing a part-time worker receiving the minimum wage could increase by 14.2%, while the cost of a full-time worker receiving the minimum wage could increase by 10.2%. Overall, the hospitality and retail sectors, where the skew is towards low-pay workers, will face the largest increase in costs.[2]

Where pay is close to or at the NLW, businesses cannot absorb increased labour costs through less generous pay growth. Instead, the more likely margins of adjustment are reduced employment and hiring. This has been borne out in the data since the NICs and NLW changes were announced at the Autumn Budget. The reduction in payrolls over the last six to nine months has been concentrated in the lower-paying part of the private sector, such as the hospitality and retail sectors. The decline in employment in the lower-paying industries in the private sector has been matched by reduced hiring, with more pronounced falls in job openings in those parts of the economy.

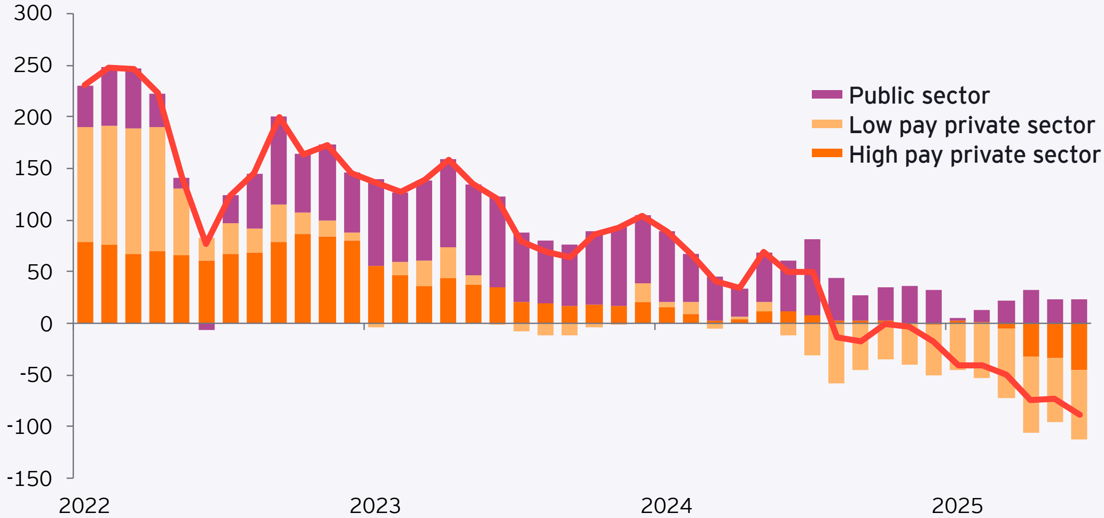
However, there is less evidence that recent policy changes are having adverse effects on sectors that typically pay higher wages. Although pay growth at the top of the income distribution has been lower, it has not slowed more quickly, which may be a sign that businesses are passing on the cost to consumers, rather than back to workers.

Nevertheless, we expect this to be a one-off effect, with the impacts set to wane in 2027. We do not expect further large rises in the NLW or employers' NICs. As the effects of these policy changes dissipate and GDP growth starts to pick up again, we expect unemployment to decline and labour cost growth to normalise in 2026 and 2027.

The public sector will not be impacted by the change in employers' NICs, as public bodies will be compensated for the increase. However, changes in public sector employment could also contribute to a loosening labour market. Since the pandemic, the public sector — primarily in health and education — has accounted for the majority of the new jobs created, reflecting a sustained rise in day-to-day public spending. We expect this support to slow as fiscal policy tightens. However, with its commitment to continue funding increases in healthcare spending, we do not anticipate a sharp decline in public sector job creation.

UK: Change in payrolled employment

000s, 3m change

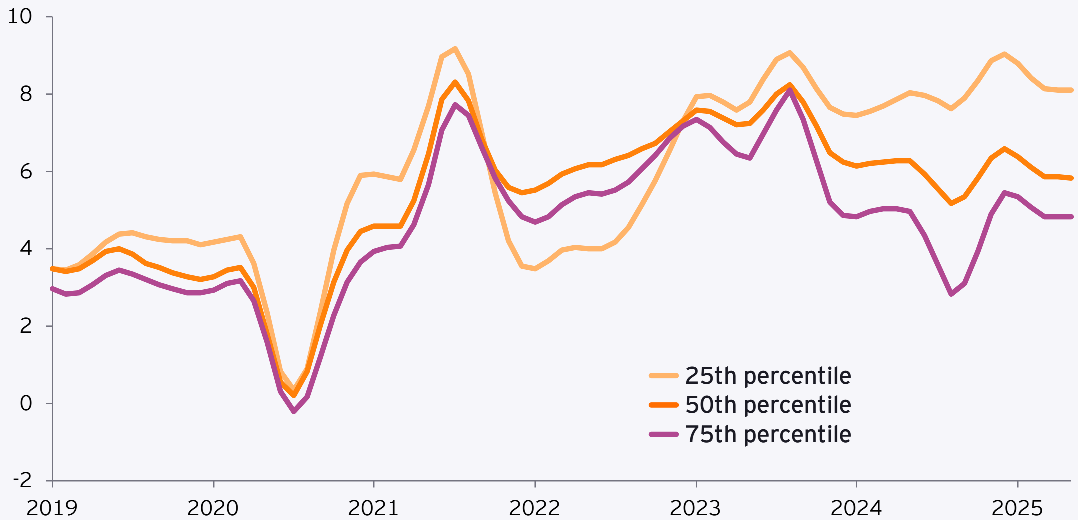


UK: Change in vacancies

% change compared to 2024 average

UK: Pay growth across the earnings distribution

% year, 3m average



Sources: EY ITEM Club/Haver Analytics

Having jumped in April, inflation will stay high for the rest of the year

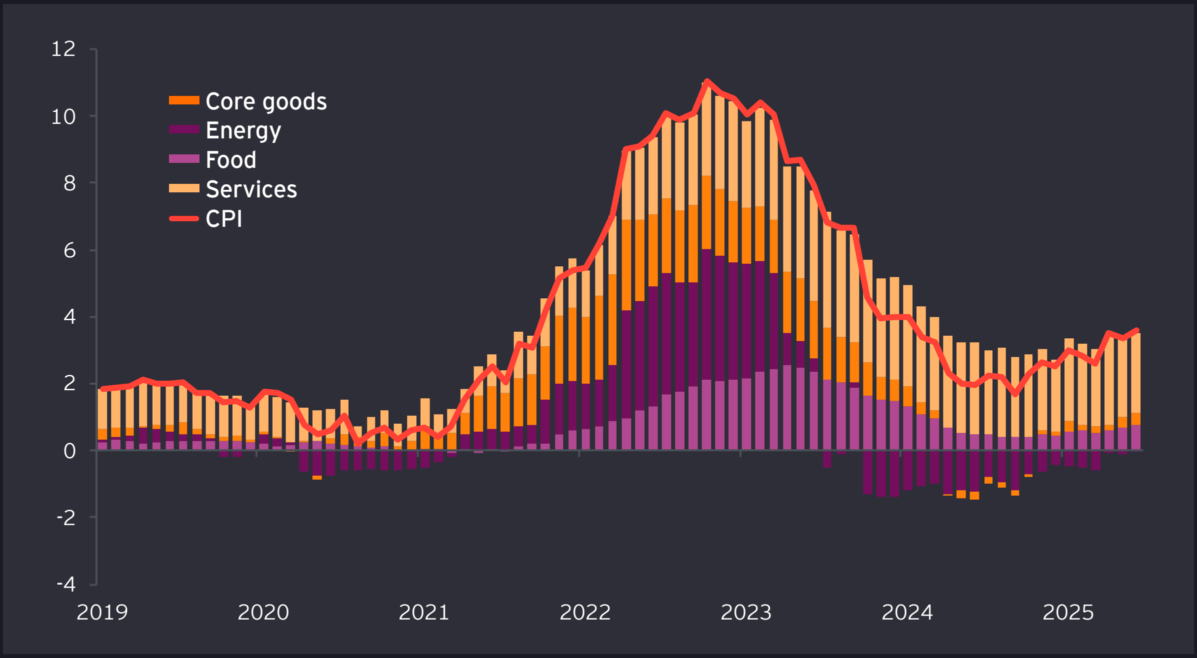
Significant regulated price increases caused headline inflation to rise to 3.4% in April, increasing to 3.6% by June. In part, the pickup reflected the sharp rise in wholesale energy prices at the start of this year, which fed through to households' energy bills. Additionally, many prices that are set annually, for example, water and broadband bills, were increased in line with past inflation. Furthermore, food and drink prices have also increased sharply and are now 5% higher than 12 months ago. But if we scratch below the surface, there are some signs that inflationary pressures are easing. Services prices are a good indicator of domestic cost pressures, and if we look past price changes that are very volatile or indexed to past inflation, this suggests inflation is still high but has slowed.

In the very near term, inflation looks set to tick up in the third quarter as a low reading in the petrol category falls out of the annual calculation. We then expect inflation to remain above 3% for the remainder of this year as services inflation remains around its current rate. As we have shown in previous reports, the rise in employers' NICs still leaves businesses facing labour cost growth in the region of 4% to 7%, even as pay growth slows.[3] To protect margins from the increase in labour costs, price growth, particularly in the labour-intensive services sector, will remain elevated.

Eventually, we expect inflation to fall back towards the 2% target in the second half of next year. With the one-off change in NICs reflected in prices, we expect services inflation to slow back to rates consistent with inflation at the 2% target.

UK: Contributions to CPI inflation

% year



Source: EY ITEM Club/ Haver Analytics

Slow progress on interest rates to continue through the second half of the year

Having lowered Bank Rate to 4.25% at its May meeting, the Bank of England continued its established pattern of cutting interest rates by 25 basis points (bps) every other meeting, leaving interest rates unchanged in June. However, the clear message from June's meeting was that the Monetary Policy Committee (MPC) still intends to cut interest rates further, although it provided little guidance on how quickly or by how much.

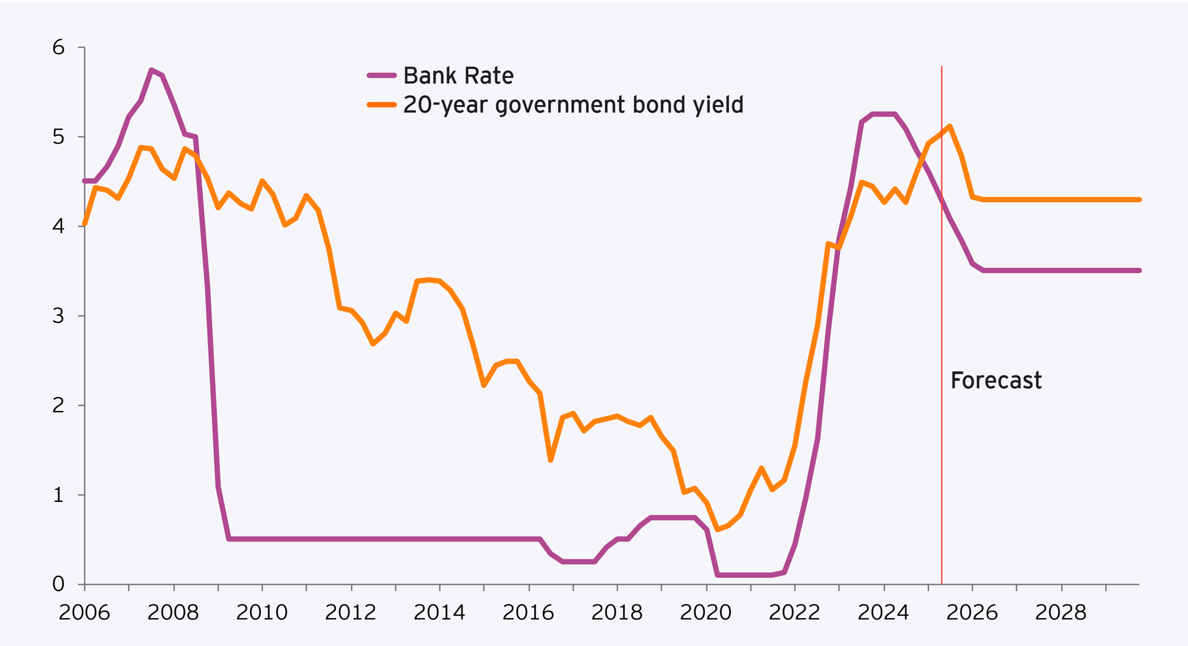
With signs that spare capacity is building in the labour market, we expect the MPC to continue cutting interest rates over the year. At recent meetings, the MPC has emphasised the level of uncertainty and unpredictability around the current economic outlook. Given that the committee remains more concerned about cutting too quickly than too slowly, we think the MPC will continue to reduce interest rates at its established pace. Overall, we expect the Bank of England to deliver two further 25-bps cuts this year, in August and November, with another 25-bps cut in February 2026, leaving Bank Rate at 3.50%. Financial markets are broadly in agreement with our projection and currently expect the Bank of England to deliver two more 25-bps cuts this year.[4]

We see risks as evenly balanced around our forecast for Bank Rate. At the June meeting, the committee began to place a greater emphasis on the softening labour market than it had done previously. On one hand, there is scope for a slightly faster pace of cuts towards the end of the year, as growth remains weak and the jobless rate rises. On the other hand, inflation has ticked up and has been a little stickier than expected. If this continues, the Bank of England may slow the pace of rate cuts from one cut per quarter to ensure inflation expectations remain anchored.

By the September meeting, the BoE will have set out how it will conduct its quantitative tightening program across the 12 months to September 2026. We expect the pace of QT to slow, with the size of the overall envelope falling from £100bn to £75bn, which would require active gilt sales of around £25bn. When it comes to QT, one of the BoE's operating principles is that it will ensure that it does not stress the gilt market. And with the international sell-off in long-dated bonds over the first half of this year, yields have risen, and swap spreads have widened. We think it's likely that the BoE will reduce its pace of balance sheet reduction, so as not to stress the market unnecessarily. Ultimately, we do expect longer-term bond yields to fall back as interest rates decline and recent concerns around global fiscal stability ease.

UK: Bank Rate and 20-year bond yield

%



Source: EY ITEM Club

Tax rises are looking more and more likely

It's no surprise that fiscal policy is expected to tighten given the difficult dynamics facing the UK following the twin shocks of the pandemic and energy price crisis. The simultaneous and sharp rise in public sector debt and the interest rates on government bonds have left the Government needing to raise tax revenues more quickly than government spending to keep the public finances on a sustainable footing.

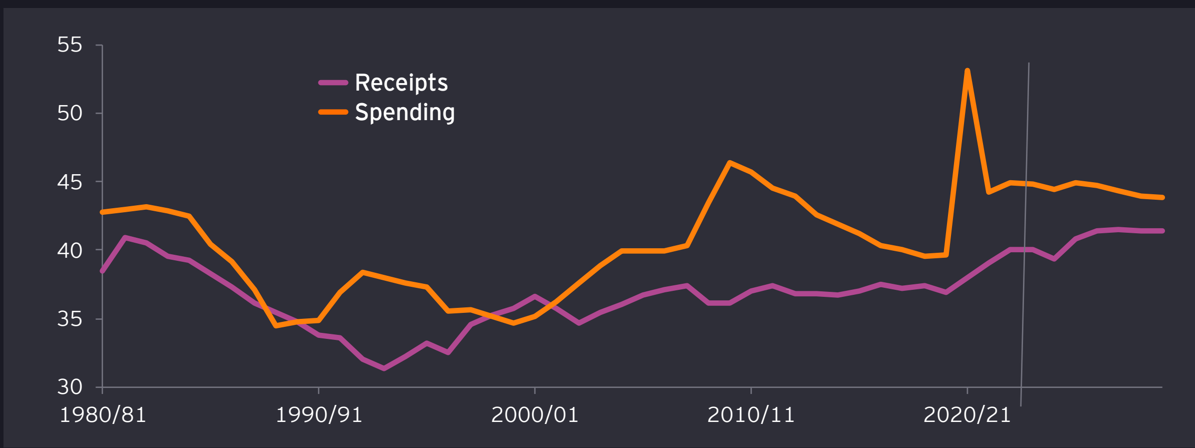
At the Autumn Budget and Spring Statement, the Chancellor used the fiscal space she had available to increase spending compared to the plans inherited from the previous Government.[5] Most departments will see their budgets increase after accounting for inflation, with total departmental spending set to rise by 1.5% per year in real terms. However, much of this additional spending reflects greater investment, with day-to-day spending settlements looking more challenging, particularly outside the protected departments, such as health.

Since the Spring Statement, the UK's fiscal challenges have been mounting. The Chancellor left herself a wafer-thin margin of £10bn against her primary rule of only borrowing to invest, but this leeway has probably already been used up. Recent changes to welfare legislation, higher bond yields and the introduction of US tariffs will increase spending and hurt tax revenues. Taken together, we think the government will need to raise additional revenue if it is to have some leeway against its primary fiscal target. However, the challenge could be even more significant if the Office for Budget Responsibility (OBR) opts to downgrade its optimistic growth assumptions at the Autumn Budget. This change could leave the Government needing to find an additional £10bn-20bn of revenue, equivalent to around 1p-2p on the basic rate of income tax – to ensure compliance with the Chancellor's fiscal rules.

At the NATO June summit, members agreed to increase the organisation's defence spending target to 3.5% of GDP by 2035, with supplementary spending on defence-related infrastructure totalling 1.5% of GDP. As it stands, the government's plans see defence spending rising to 2.6% of GDP by the end of this Parliament. However, if it is required to bring forward some defence spending to deliver a smoother path to 3.5%, it would only add to the Chancellor's headaches. Even if the bulk of new spending is capital, the increase will still threaten the Government's fiscal rules, with only £16bn of space against the Government's pledge to see the UK's financial liabilities relative to its income falling by the end of this Parliament.

UK: Tax revenues and public spending

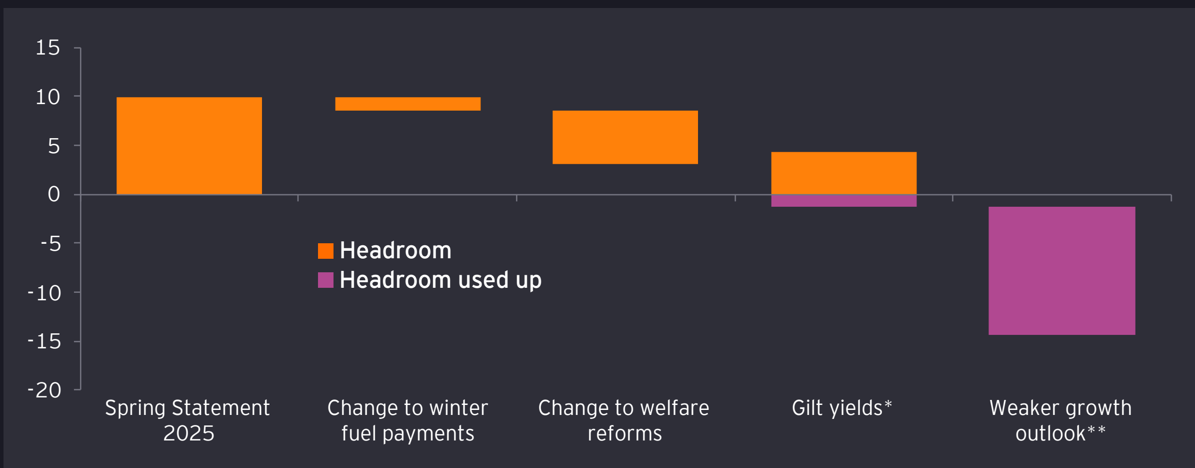
% of GDP



Source: EY ITEM Club

UK: Headroom against UK's primary fiscal rule

£bn



* gilt yields up to 14 July 2025

** OBR downgrade to match average of its high and low growth scenarios

Source: EY ITEM Club/ OBR

3

Households will show a little less caution

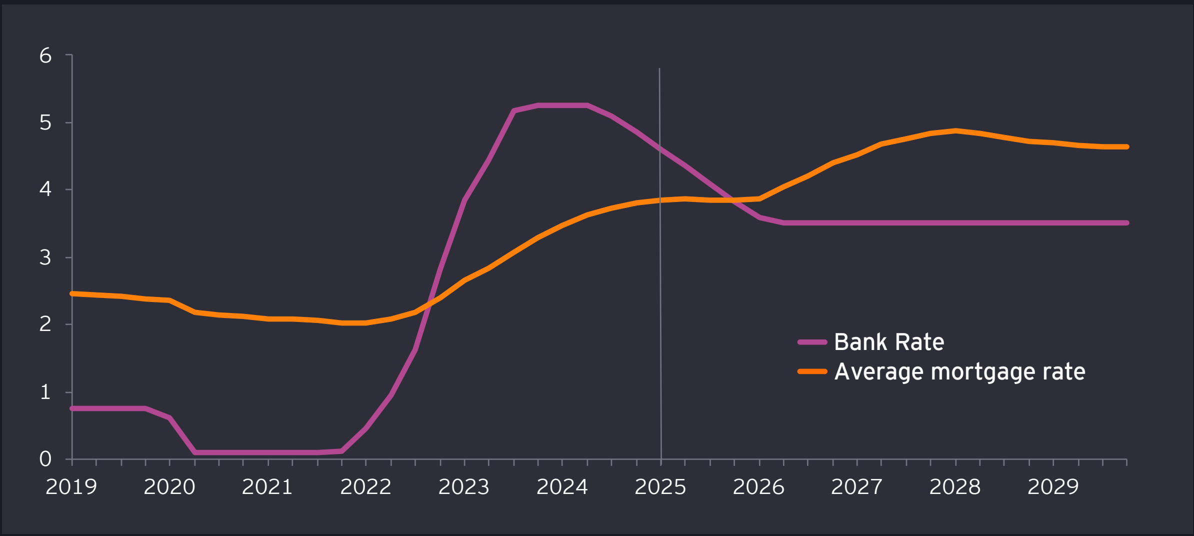
A notable feature of 2024 was that, despite households' real incomes improving markedly, spending growth has been quite muted as consumers remained cautious. Having stagnated through most of last year, there are some tentative signs that consumer confidence has improved in the last few months. How consumer caution plays out through the rest of this year will be a key determinant of the consumption outlook.

Spending has lagged income growth

Over the last couple of years, we have seen a shift in the drivers of households' real incomes. Looking back at 2022 and 2023, real income growth was driven by non-labour income. Interest income picked up as rising interest rates fed through more quickly to households' deposits than to their debts, with most mortgages on two- or five-year fixed interest rate deals. At the same time, pay growth could not keep up with the rapid rise in household energy bills, food prices, and the cost of other key goods, which squeezed household spending power. However, last year, the balance shifted. As the UK labour market remained relatively tight, pay growth remained high, with inflation falling back sharply towards 2%, meaning real earnings increased substantially. Meanwhile, interest rates were cut, and the average mortgage rate increased as households continued to refinance two- and five-year fixed-rate mortgages to higher interest rates.

UK: Bank rate and average mortgage rate

%



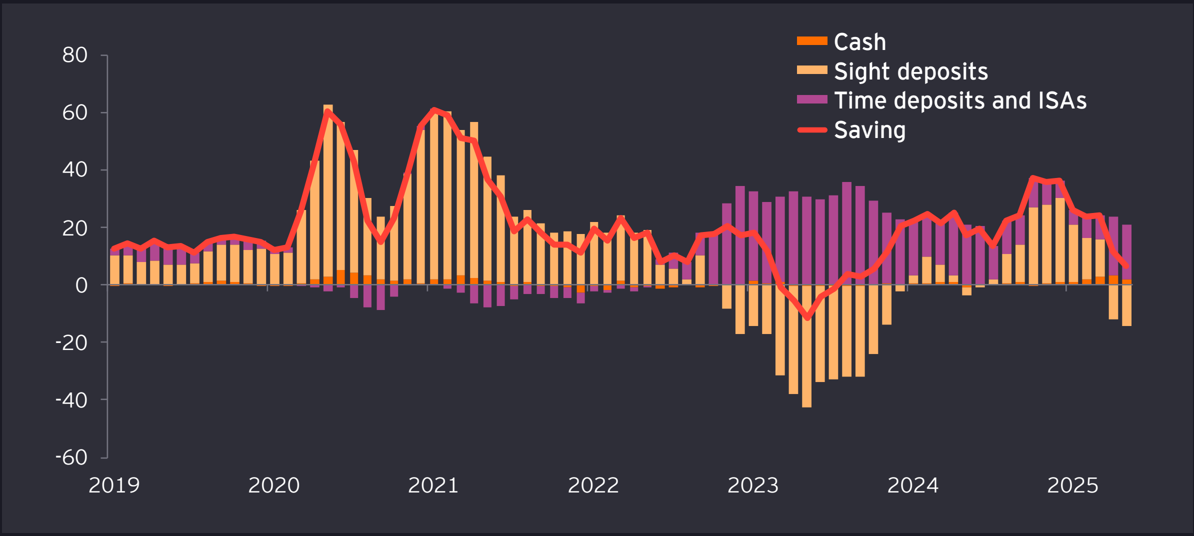
Source: EY ITEM Club/ Haver Analytics

These dynamics are also reflected in households' savings. As the pandemic struck, households saved a much greater proportion of their income as the economy was shuttered. This was reflected in middle-income households temporarily parking savings in easily accessible bank accounts. As the energy price crisis started to unfold, these buffer savings were run down. In contrast, higher-income households started to invest more heavily in higher-yielding bank accounts, where the money is locked away for a fixed period, as interest rates rose. However, more recently, we have seen another shift. Once again, households are saving more in sight deposits as consumer caution leads to more 'rainy day' savings being built up.

Looking forward, real income growth is going to slow over the next couple of years. Inflation is set to remain around 3.5% while pay growth is likely to slow further over the course of the year. Combined with higher unemployment, frozen income tax thresholds, and falling interest rates, real disposable income growth will invariably slow from around 4% in 2024 to around 1.7% in 2025 and 0.3% in 2026.

UK: Flow of saving by type

£bn



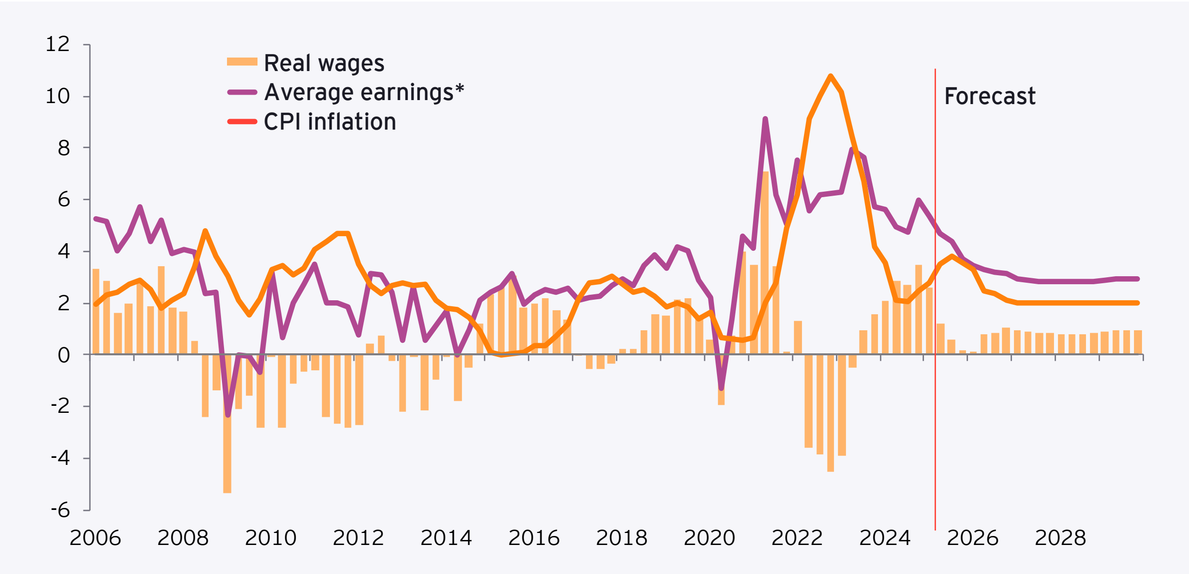
Source: EY ITEM Club/ Haver Analytics

Reduced saving will support consumption going forward

With signs that the recent build-up in savings has been precautionary, we expect consumption growth to hold up over the next couple of years as households save a little less of their income. We see positive fundamentals within the household sector. Households' asset and liability positions are very healthy by historic standards, with the household debt-to-income ratio lower than it was before the pandemic, and we only expect a slight rise in the unemployment rate. At the same time, with price rises in some household essentials, such as food and energy, there will also likely be some forced dissaving. We expect consumption growth to pick up from 0.6% in 2024 to 0.9% in 2025 and 1.1% in 2026.

UK: Average earnings and inflation

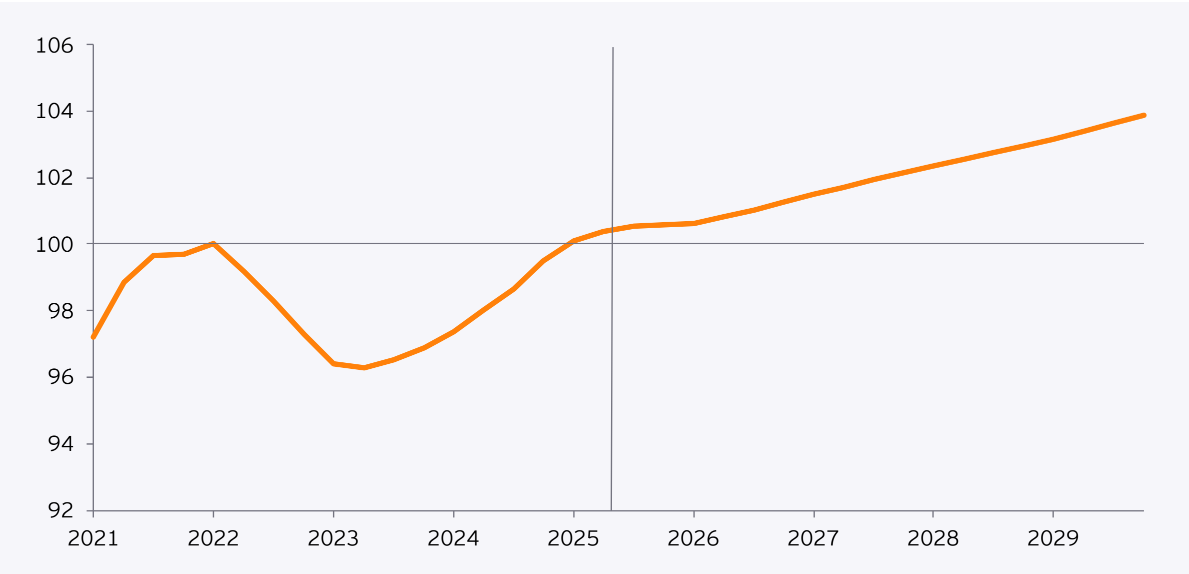
% year



Source: EY ITEM Club

UK: Real earnings*

2022 Q1, 4q average = 100



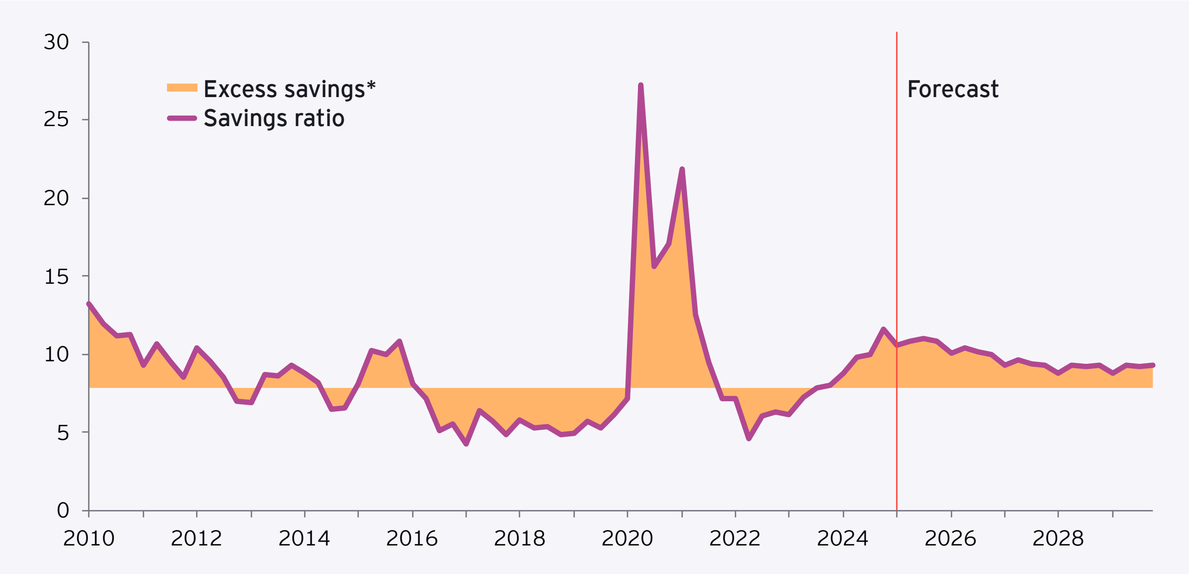
* National accounts measure

Source: EY ITEM Club

Nonetheless, with significant economic uncertainty still apparent, we do think that some consumer caution will remain. We expect the savings ratio to fall from around 10.5% in Q1 2025 to around 9.5% by the end of 2027. This adds around 1% to the level of consumption and still leaves the savings ratio around 1.5 ppts above its long-term average. Over the last few years, consumer caution has led to a decline in the purchase of big-ticket items, resulting in reduced spending on other items, which has been compounded by the increase in spending on essentials like energy and food. This is also reflected in more discretionary services, such as accommodation, food and entertainment. Across these services, business has not recovered to its pre-pandemic level, compounding the impact of the rise in NICs and NLW to which these firms are most exposed.

UK: Household saving ratio

% of disposable income

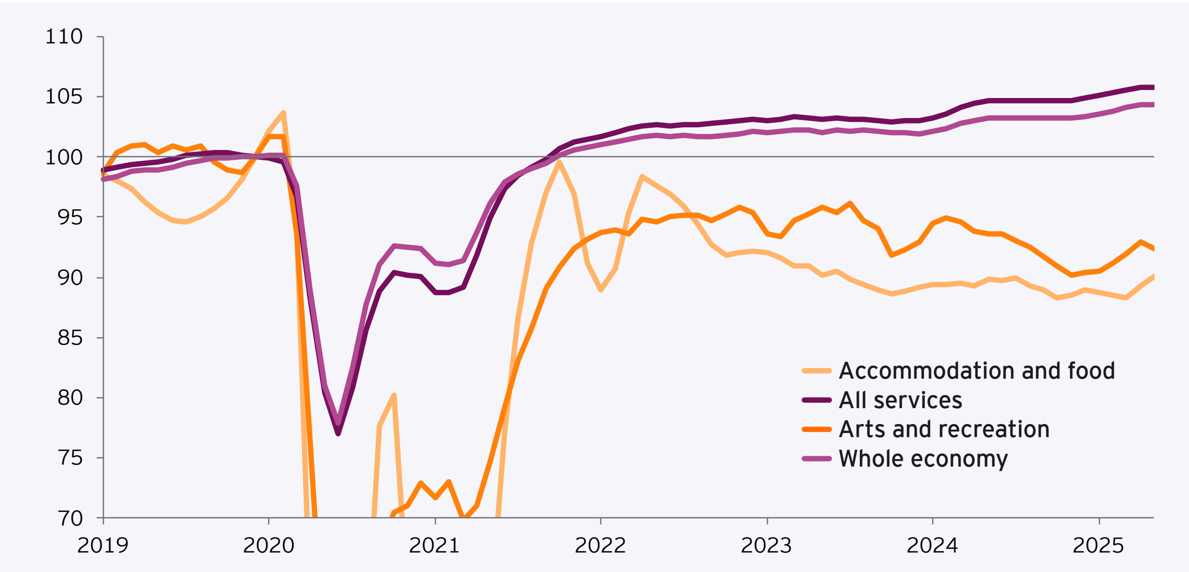


* Relative to 2010-2019 average

Source: EY ITEM Club/ Haver Analytics

UK: Gross value added

2019 Q4 = 100



Source: EY ITEM Club/ Haver Analytics

The extent to which households opt to save a smaller proportion of their income is a key judgement underpinning our forecast. A simple sensitivity analysis shows that if the savings rate simply returned to historic norms, average growth could be between 0.25 ppts and 0.5 ppts higher per year. Conversely, if the savings rate were to remain around its current level, growth could be 0.2 ppts-0.3 ppts lower per year. However, this exercise should be taken as indicative only. It doesn't necessarily capture the broader effects that stronger or weaker household spending would have on the labour market, pay or wider economic conditions, or their feedback loops into GDP and consumption growth. If household saving rates were to fall by less than we expect, it is not necessarily a negative outcome. Greater household savings can help the UK to build its self-reliance through greater funding for domestic investment and a narrowing of the current account in the long run.

The housing market will recover from a soft patch, but the Government's house-building targets look challenging

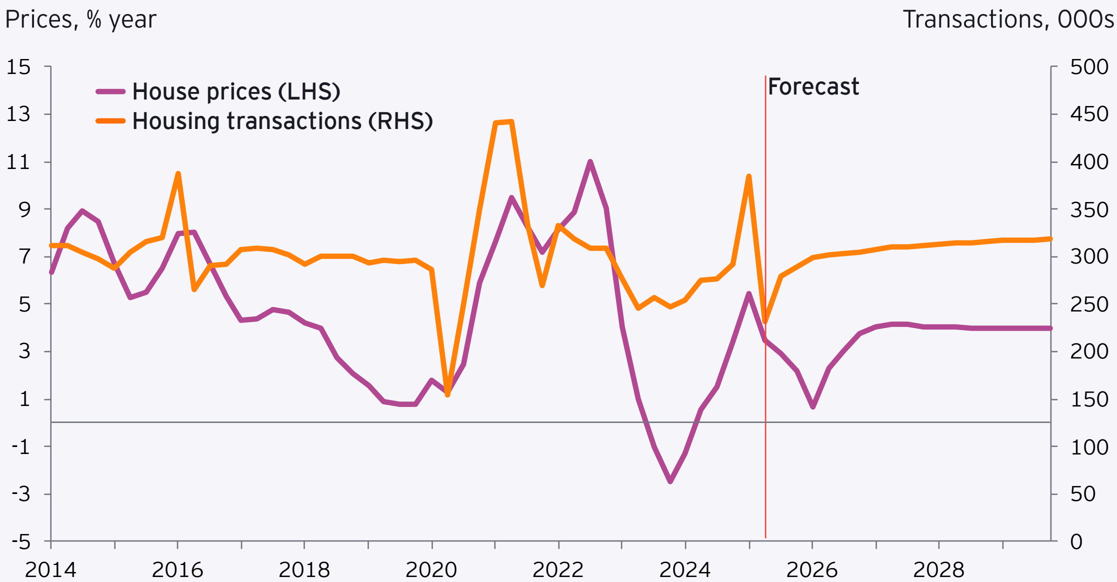
The housing market started the year on a very strong footing, but that largely reflected a temporary boost in demand as house buyers rushed through purchases ahead of the change in Stamp Duty thresholds at the start of April. Housing transactions picked up through Q1 and then dropped sharply in April, falling to the second-lowest level since 2016. Transactions picked up in May, but remained depressed, sitting 12% below the number of transactions twelve months ago. In recent months, there has been some volatility in house prices as the effects of the Stamp Duty change work their way through the market. However, there are already signs that this is starting to fade. In May, mortgage approvals picked up again and given the lag between mortgages being approved and transactions being completed, the rebound in housing activity is likely to continue over the coming months and into the second half of this year.

New mortgage rates have fallen back in recent months as financial markets have priced more Bank of England cuts than they had expected around the turn of the year. We think new mortgage rates could fall back a bit further this year as the BoE delivers rate cuts in line with market expectations. However, housing affordability remains stretched, and with ongoing uncertainty and the likely rise in unemployment, we believe some potential buyers may hold off on making a house purchase as they await more clarity on the economy's direction. Having fallen in Q2, we expect a modest improvement in the housing market across the second half of this year. Overall, we forecast house prices to increase by 3.5% this year, which is flattered by a very strong Q1 reading, and by 2.4% next year.

In December, the Government updated the National Planning Policy framework, outlining planning reforms that it believes will boost house building over the coming five years.[6] In the Spring Statement, the OBR responded by pushing up its forecast for the UK housing stock by 170,000, with most of the uplift coming from the requirement to release local authority land.

However, we think the evidence so far is that there will be some challenges in boosting house building. Completions by the end of 2024 were lower than they were in 2019. The incentives to build new housing remain relatively weak, with house prices having behind lagged the cost of construction in recent years. At the same time, labour shortages have continued to plague the sector, making it difficult to rapidly increase house building. Housing investment has been weak over the last few years and is yet to regain its pre-pandemic level. With many of the headwinds likely to persist, we expect housing investment to be relatively modest compared with official forecasts. We expect annual housing investment growth to peak at around 3% in the coming years, which is notably softer than the OBR's forecast, which reaches above 9%.

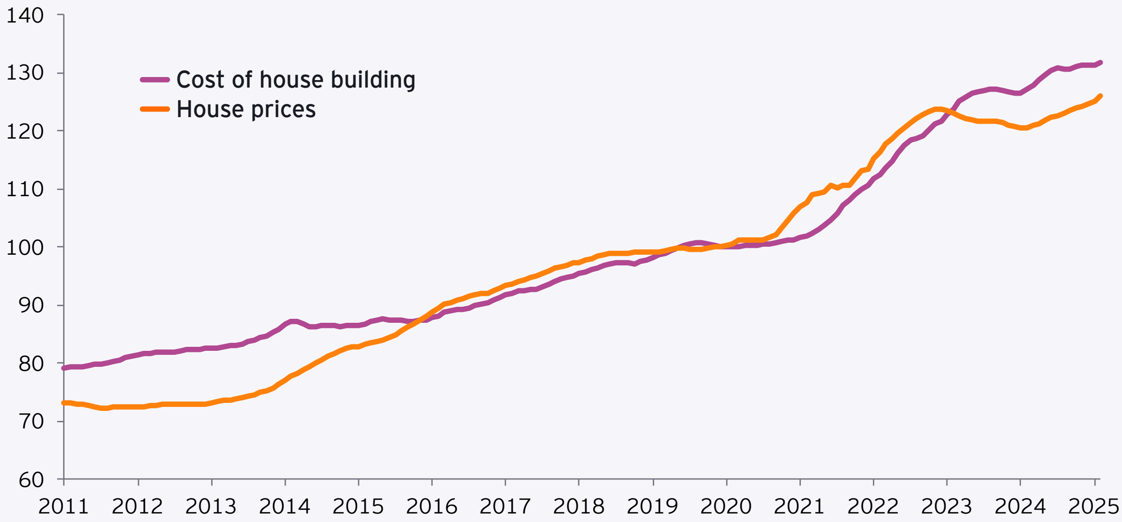
UK: House prices and transactions



Source: EY ITEM Club

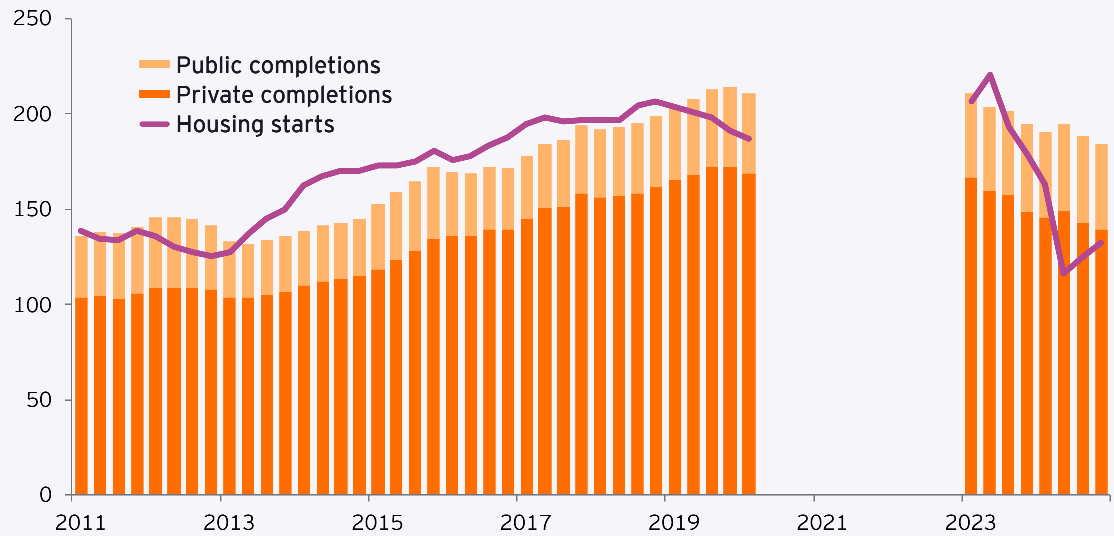
UK: Cost of house building and selling price

2019 Q4 = 100



UK: Housing starts and completions

000s, four quarter sum



Sources: EY ITEM Club/Haver Analytics

4

Ongoing uncertainty will continue to hold back investment

Despite a very strong start to the year, we expect a relatively muted pace of business investment for the rest of this year and into next. But underlying that, we do see scope for capex to pick up into 2027 as the outlook becomes a little bit more certain.

Investment fundamentals have been challenging

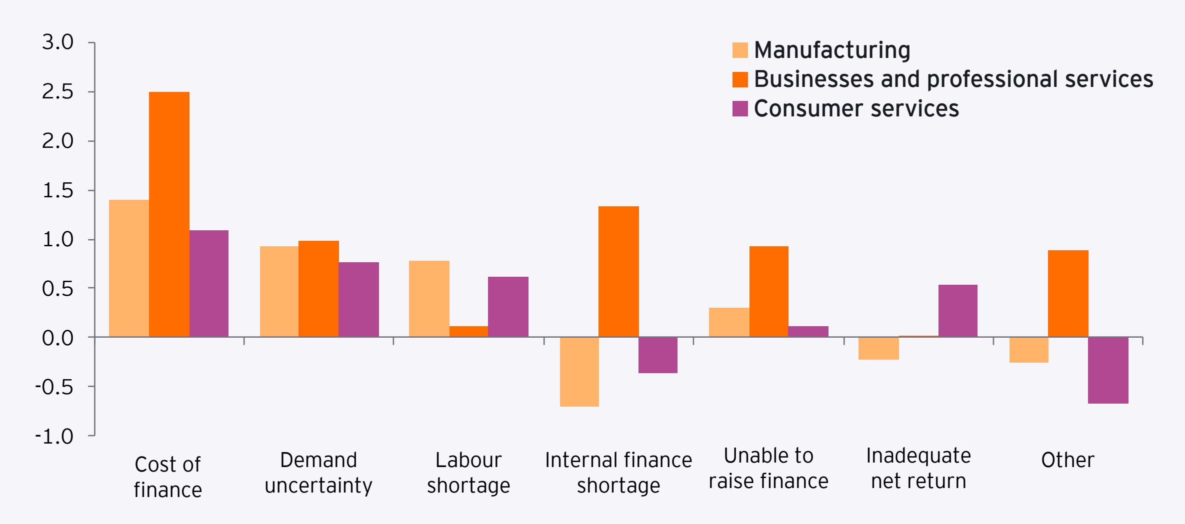
Over the past two years, business investment has grown more quickly than the broader economy, closing the shortfall to its pre-pandemic level. However, that does not mean businesses have faced a favourable backdrop. Still, we do see some of these pressures abating over the coming years.

Across most parts of the economy, there is no shortage of projects that offer the necessary return to warrant investment. In the middle of 2025, as part of a CBI survey, manufacturers and professional services firms indicated that there are at least as many viable investment opportunities as is normally the case. Consumer services were a little bit more pessimistic, but this is no surprise given the sector's exposure to the recent increase in employers' National Insurance Contributions.

Instead, firms are struggling with access to and the cost of finance, with this echoed across the main sectors of the economy. Unlike households, around 80% of business debt is issued at floating interest rates, so corporate debt servicing costs are much more sensitive to changes in interest rates. During the Bank of England's recent rate-hiking cycle, the average interest on corporate debt increased by more than 400 bps, whereas households have only seen the mortgage rates rise by around half that amount to date.

UK: Limits on investment in 2025 Q2

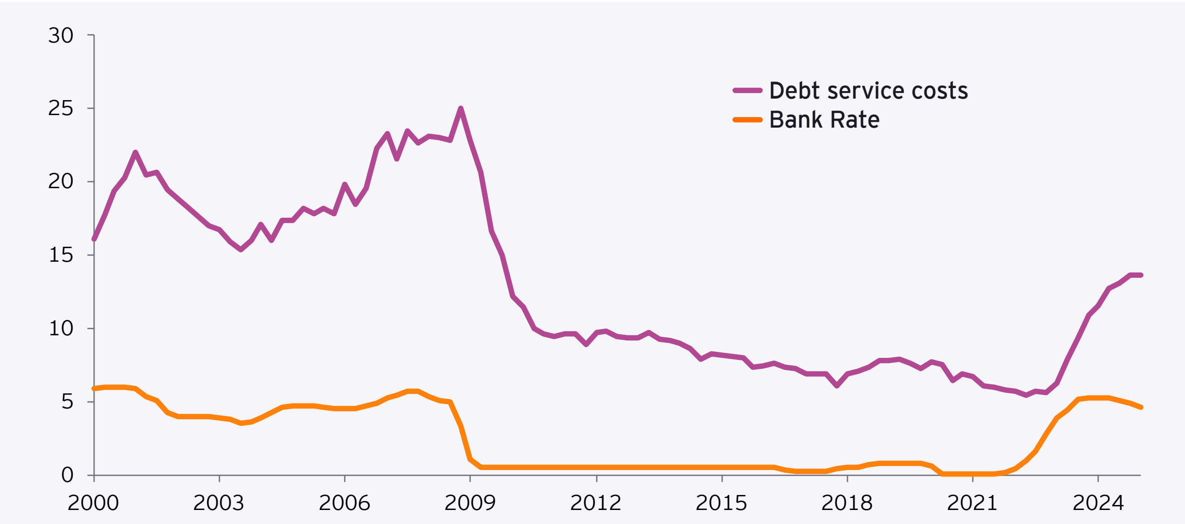
Standard deviations from 2000–2024 average



Source: EY ITEM Club/ Haver Analytics

UK: Corporate debt services costs and interest rates

%, % of corporate profits



Source: EY ITEM Club/ Haver Analytics

Like households, businesses have used some excess savings to absorb the rising cost pressures in recent years. As the pandemic set in and corporate loan facilities were put in place, many businesses used this as an opportunity to access relatively cheap funds that they then held in reserve.

In response, corporate deposits shot up, reaching almost 25% above their trend. As corporate costs have risen and growth has been weak, a lot of this excess saving has now been used up, with deposits dropping back towards the trend level.

Interest rate cuts will support investment

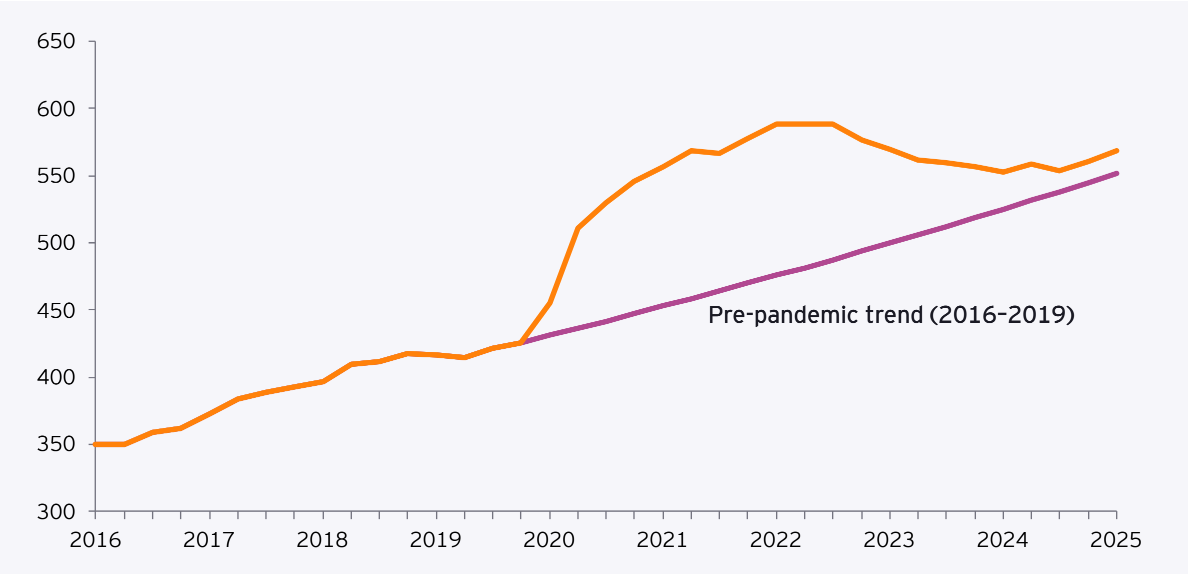
The outlook for businesses' debt service costs is positive. We continue to expect interest rates to fall over the latter half of this year and into the start of next year. In response, firms' debt servicing costs should decline, too. All else being equal, this would boost capital expenditures (capex), particularly given that firms still have relatively healthy balance sheets. However, we do not think interest rates will fall back to the level we saw before the pandemic, leaving firms' debt service costs at a higher level than we saw over the period between 2010 and 2019.

But economic uncertainty presents a headwind

We think there will be a delay before falling interest rates start to boost business investment. There remains considerable uncertainty about how the economy will develop. Given this, firms are likely to delay some capex decisions until they have greater clarity on the potential returns that investments may yield. As a result, reported investment intentions have sunk at the start of the year in response to souring business sentiment.

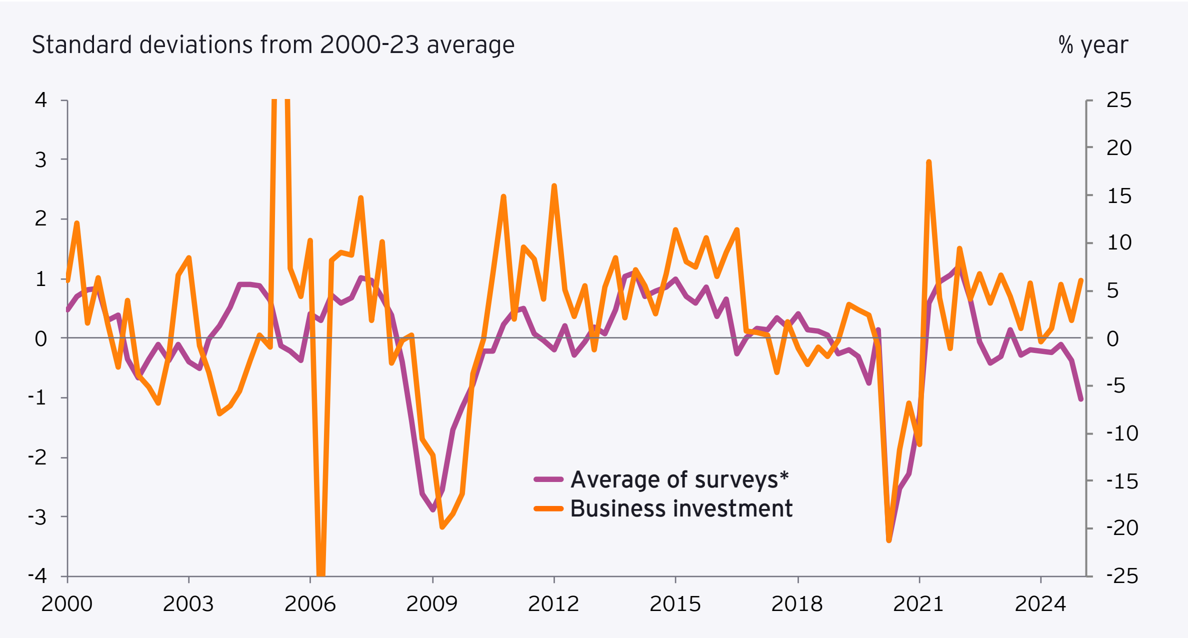
UK: Private non-financial corporate deposits

£bn



Source: EY ITEM Club/ Haver Analytics

UK: Business investment and investment intentions



* CBI, BCC and BoE Agents

Source: EY ITEM Club/ Haver Analytics

Investment will move sideways through most of this year

Business investment picked up sharply in the first quarter of 2025. However, as we mentioned earlier, a significant portion of this strength is due to a one-time purchase of aircraft, so we expect a reversal in Q2. After that, business investment is projected to be broadly flat in the latter half of this year, growing by just 0.1% to 0.2% as elevated economic uncertainty and ongoing cost pressures from the rise in the NLW and NICs broadly offset the boost from falling interest rates. As these headwinds fade, and with the cost of debt servicing and new finance lower, we forecast investment to pick up gradually in H1 next year and settle around an annualised rate of 1.7%.

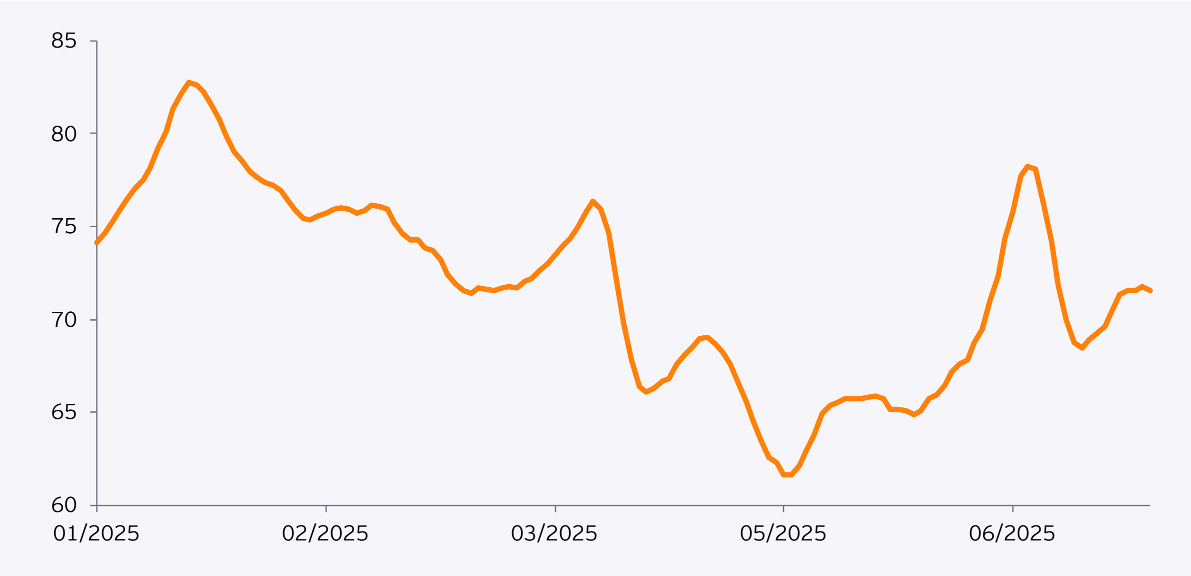
Geopolitics continues to pose the biggest risk to the outlook

A major risk to the outlook, and particularly to firms, is ongoing geopolitical tensions, which could disrupt both supply chains and commodity markets. They also heighten economic uncertainty. The financial implications of geopolitical risks are difficult to quantify. However, the recent conflict in the Middle East provides a case study.

The tensions in the Middle East led to a temporary spike in energy prices. As the Israel-Iran conflict commenced, oil prices and, to a lesser degree, gas prices spiked. Oil prices rose from around $65 per barrel at the start of May to over $80 per barrel at their peak. Following the ceasefire, prices eased. If the ceasefire were to break and oil prices returned to and remained at $85 per barrel, then GDP growth could be 0.2 ppts weaker, and inflation could rise by a similar amount, peaking at around 4% later in the year.

Global: Brent crude oil price

$ per barrel, 5 day average



Source: EY ITEM Club/ Haver Analytics

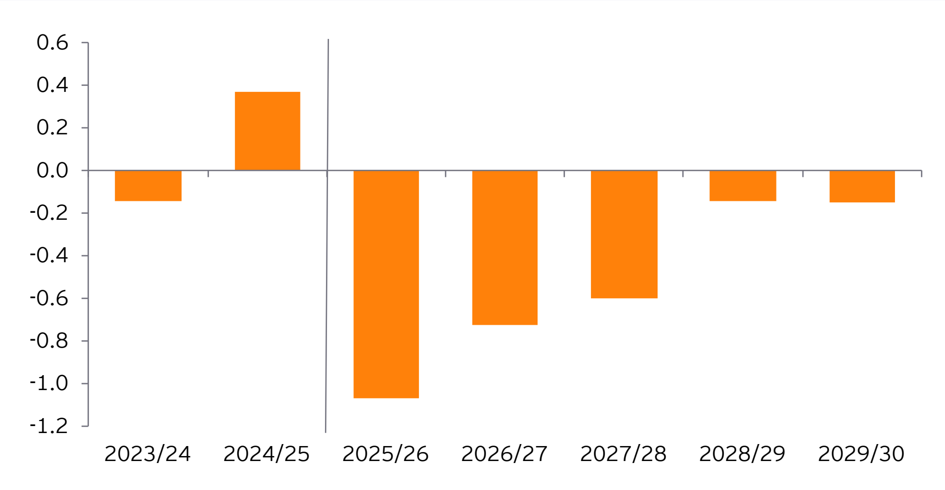
Forecast in charts

Fiscal policy

- The combination of a large stock of public debt, high interest rates, and low potential growth present a set of challenging fiscal dynamics.
- To keep the public finances on a stable footing, the government will have to reduce borrowing and has pledged to only borrow to invest.
- But since the government's Spring Statement, fiscal headwinds have intensified. Our forecast suggests either more tax rises or spending cuts will be needed to restore some headroom against the current fiscal rules.

UK: Change in public sector borrowing

% ppt of GDP



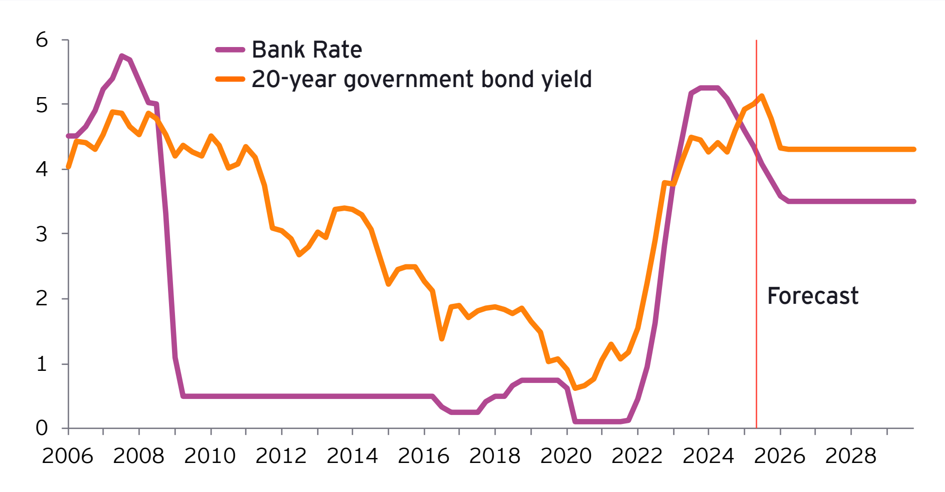
Source: EY ITEM Club

Monetary policy

- The MPC has continued to cut interest rates once per quarter, lowering Bank Rate to 4.25% in May. We expect a further 25 bps cut to 4.00% in August.
- With inflation lingering above target and pay growth still well above a target-consistent pace, we think that the MPC remains more concerned about cutting too quickly than too slowly. Therefore, we expect the pace of cuts to remain gradual, with Bank Rate forecast to fall to 3.75% by the end of 2025 before settling at 3.5% in early 2026.
- We see the risks to our forecast for Bank Rate as evenly balanced. If inflation is stickier than we expect, the pace of interest rate cuts may slow. But if the jobs market weakens sharply, the BoE may speed up the cutting cycle to support employment.

UK: Bank Rate and 20-year bond yield

%



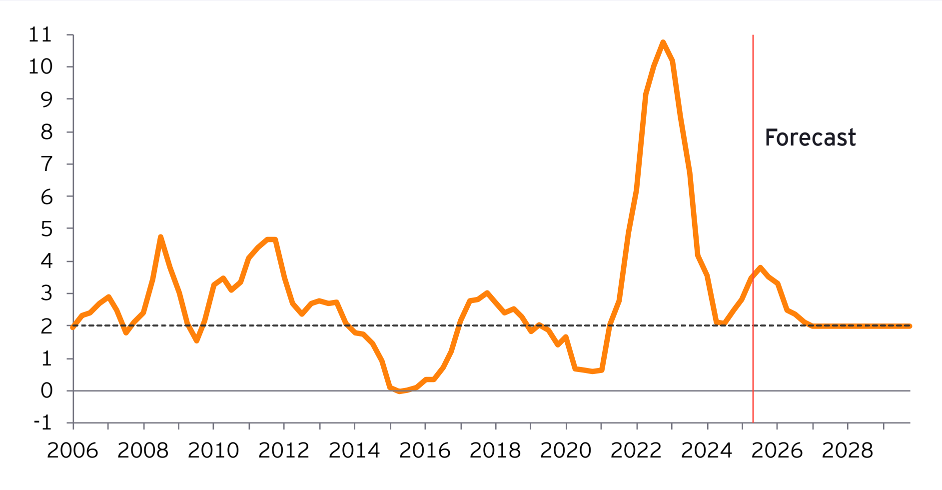
Source: EY ITEM Club

Prices

- Inflation picked up to 3.6% in June and has remained around that level since, reflecting the rise in household energy bills and regulated prices, such as water bills, that often change once per year. The recent rise in food prices has also put upward pressure on headline inflation in recent months.
- The rise in employers' NICs will keep labour cost growth high, even as pay growth cools. This should keep inflation above 3% in H2 2025.
- Ultimately, with the one-off change in NICs, looser labour market conditions and softer wage growth will feed through to services inflation. Headline inflation is expected to return to target in the latter half of next year.

UK: CPI inflation

% year



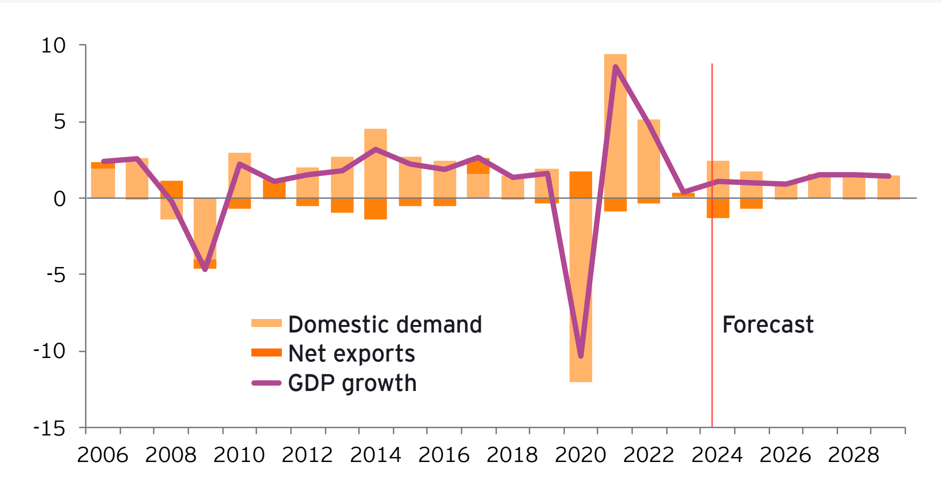
Source: EY ITEM Club

Activity

- GDP growth made a very strong start to the year, growing by 0.7% in Q1. However, we believe some quirks in the data render this strength temporary, and higher-frequency indicators suggest that momentum has faded.
- Despite the US-UK trade deal, US tariffs on UK goods exports are still set to rise sharply. Reduced access to its largest export market will weaken export performance, while uncertainty will see some spending decisions postponed, particularly among corporates.
- These factors will continue to weigh on demand into 2026, but slowly fade, and growth will return towards the trend in 2027.

UK: Contributions to GDP growth

% year



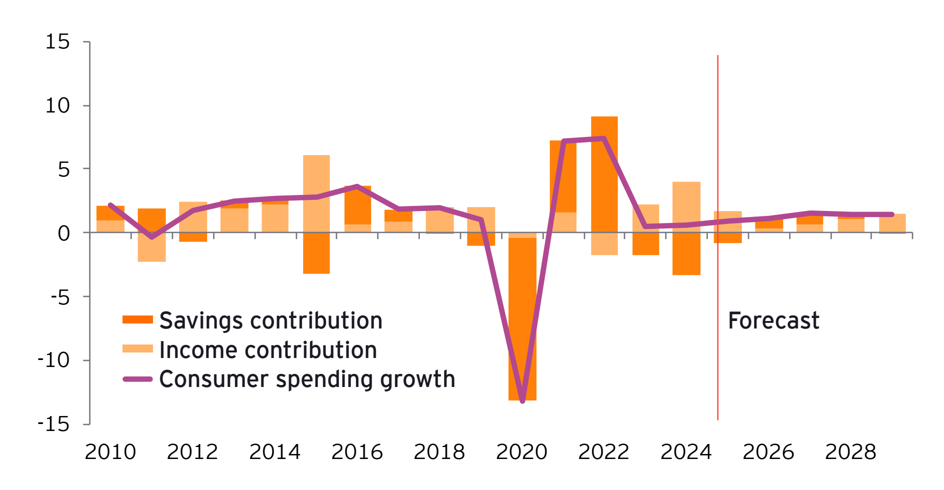
Source: EY ITEM Club

Consumer demand

- Over 2024, real incomes picked up sharply as wage growth remained strong and inflation fell back to target. But consumption growth remained relatively muted.
- Over the next couple of years, real income growth is set to slow, but we expect consumption growth to remain steady as households become a little less cautious.
- With fundamentals in the household sector looking solid, we expect the household saving ratio to fall back towards its long-run average. With uncertainty still lingering, it is likely to remain higher than historical norms.

UK: Contributions to consumer spending growth

% year



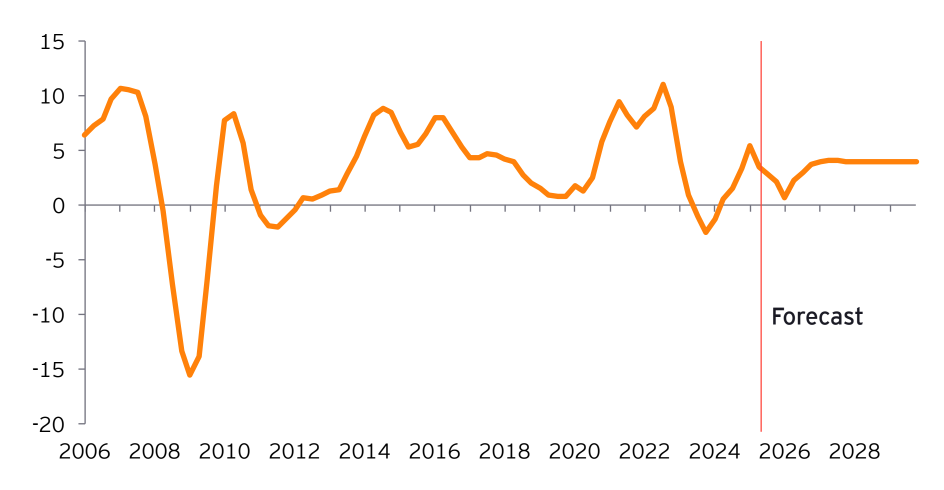
Source: EY ITEM Club

Housing market

- With some transactions having been rushed through to beat April's change in Stamp Duty thresholds, the housing market is now going through a soft patch. However, we think this will prove only temporary.
- We expect modest housing market performance in the second half of this year. We forecast interest rates are set to fall further, and we do not expect a large rise in unemployment, but affordability remains challenging.
- Given the scale of the rise in construction costs and ongoing labour shortages, a rapid increase in UK home building over the coming years remains a distant prospect.

UK: House prices

% year



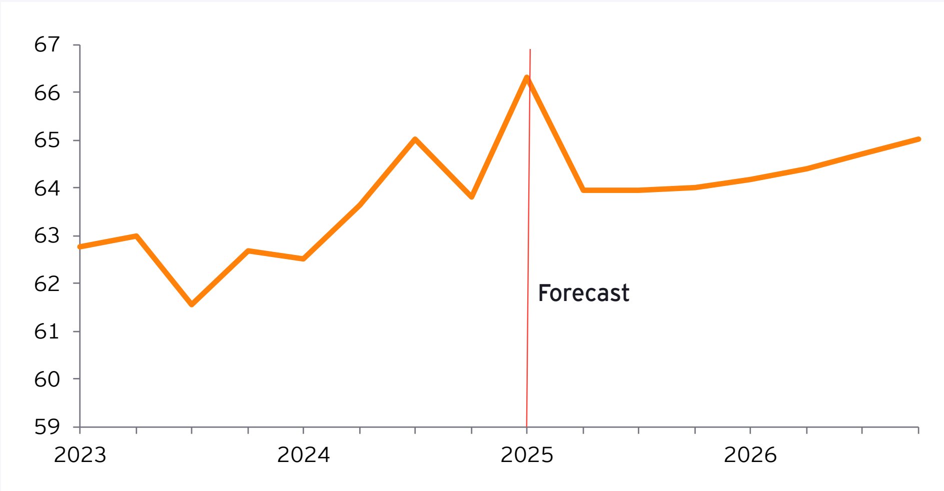
Source: EY ITEM Club

Company sector

- Business investment picked up sharply in Q1, but we think that this strength is temporary as it reflects the one-off purchase of aircraft.
- We forecast investment to move sideways through the second half of this year and the start of next year as economic uncertainty continues to see businesses postpone some major capex decisions.
- Firms report no shortage of feasible investment opportunities, so as interest rates fall, reducing debt servicing costs and new finance becomes less expensive, we expect investment growth to pick up through the second half of next year.

UK: Business investment

£bn



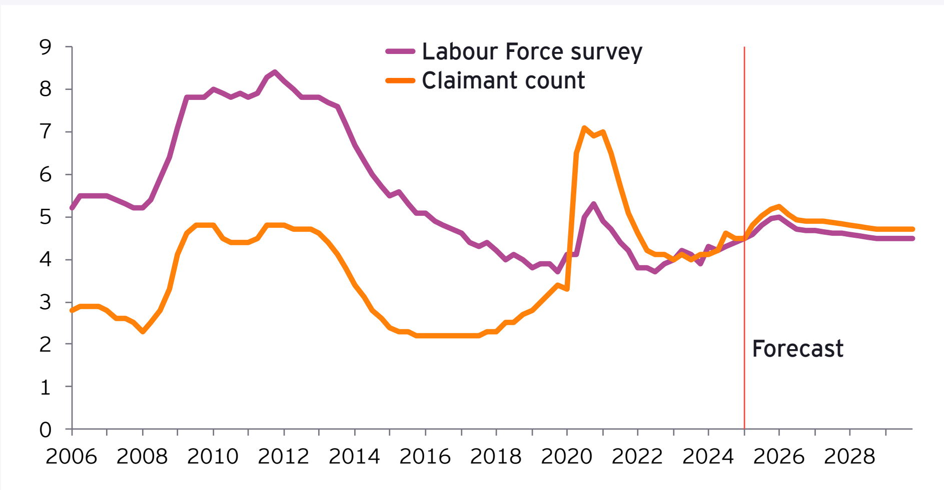
Source: EY ITEM Club

Labour market and wages

- Having been very tight in mid-2023, a couple of years of muted growth have seen the labour market loosen as businesses have lowered headcount through reduced hiring rather than layoffs.
- The rise in employers' NICs and the NLW has raised cost pressures for businesses. This has led to a decline in employment in lower-paying sectors.
- We expect continued weak GDP growth to result in a further rise in the unemployment rate, but the increase will be small compared with some other periods, for example, the GFC.

UK: Unemployment rate

%



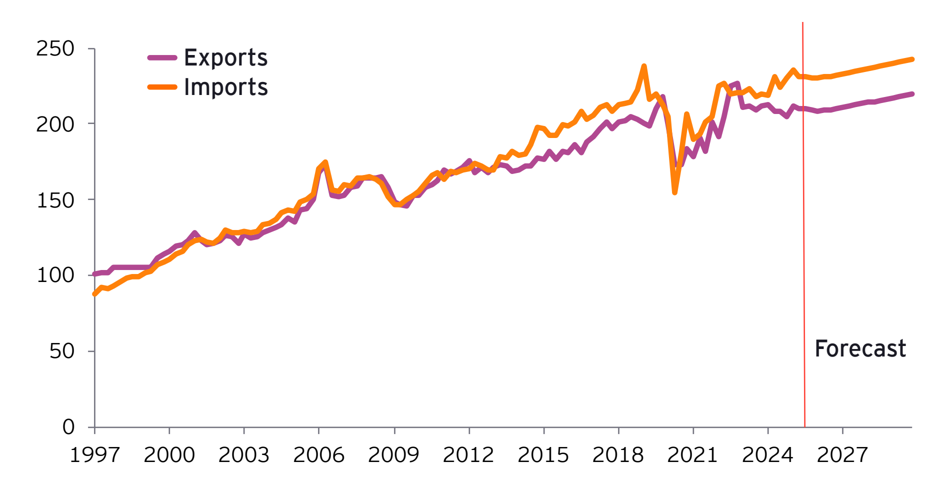
Source: EY ITEM Club

Trade and the balance of payments

- The US-UK trade deal still leaves UK goods exports facing much higher tariffs than at the start of this year, while global growth also looks set to slow.
- Growth in UK exports is forecast to slow in the face of reduced access to a key export market and weaker demand growth in a weakening global economy.
- There has not been a direct response to US tariffs from the UK Government, but we expect weaker domestic demand and reduced world trade to result in softer import growth.

UK: Export and import penetration

£bn, 2022 prices



Source: EY ITEM Club

Endnotes

1. EY ITEM Club (2025) "EY ITEM Club Spring Forecast – April 2025"
2. Cominetti and Thwaites (2025) "Minimum wage maximum pressure"
3. EY ITEM Club (2025) "EY ITEM Club Winter Forecast – February 2025"
4. As of 17 July 2025, after the publication of the labour market data for May/June.
5. Arnold (2025) "Spending Review: Chancellor bets big on investment to drive the growth needed to balance the books"
6. UK Government (2024) "National Planning Policy Framework"

About EY ITEM Club

EY ITEM Club is the only non-governmental economic forecasting group to use the HM Treasury's model of the UK economy. ITEM stands for Independent Treasury Economic Model. HM Treasury uses the UK Treasury model for its UK policy analysis and Industry Act forecasts for the Budget. EY ITEM Club's use of the model enables it to explore the implications and unpublished assumptions behind government forecasts and policy measures.

Uniquely, EY ITEM Club can test whether government claims are consistent and can assess which forecasts are credible and which are not. Its forecasts are independent of any political, economic or business bias.

EYSCORE 005726-25-UK
ED None

ey.com/uk/item